Shadow Banking in India &

The Lender of Last Resort

(A Perspective)

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Abstract:

If Banking Industry is the ‘mover’ in any economy, Shadow Banking (especially the Non Banking Finance Institutions/Corporations) is but the vital cog in its armoury. Non-Banking Financial Institutions/Companies (NBFIs/ NBFCs) are entities or institutions that provide certain bank-like and financial services, but do not hold a banking license. NBFCs/NBFIs play many essential roles that banks fail to act upon. They provide complementary services to the economy. Indeed this ‘shadow banking’ industry running parallel to the Banking industry provides a bigger challenge for the Regulator. According to the RBI Financial Stability Report, 2018, the Non Banking Financial Services is the Biggest single most entity that owes money. Be it the absence of reclassification option, or re-financing tools, lack of capacity-building or lack of statutory recovery tool, to limited leverage ratio – all played their roles to get the shadow banks mired into a full blown crisis. The importance of the NBFC contributions to the Indian economy also made the Central Bank Governor state that, ‘It is our endeavour to have an optimal level of regulation and supervision so that NBFCs are financially resilient and robust’.

Index Terms:

Shadow Banking, Non-Banking Financial Corporations, Reserve Bank of India, NBFC Crisis, Regulation, Solutions

I. INTRODUCTION:-

As messages go, the Reserve Bank of India (RBI) governor Shaktikanta Das gave a Panglossian one, expressing yet again the central bank’s resolve to help the non-banking financial companies (NBFCs) weather the crisis they are mired in currently (The Mint, Aug 19, 2019& RBI Bulletin, Sept 12, 2019).

“It is our endeavour to have an optimal level of regulation and supervision so that NBFCs are financially resilient and robust. We will not hesitate to take whatever steps are required to maintain financial stability in the short, medium and the long-term,” the RBI Governor said.

What then are the testing challenges & concerns engulfing the ‘Shadow Banks’, today?

II.CONTEXT SETTING:-

II.1. SHADOW BANKING:-

If Banking Industry is the 'mover' in any economy, Shadow Banking (especially the Non Banking Finance Institutions/Corporations) is but the vital cog in its armoury.

The term shadow bank was coined by US economist Paul McCulley in 2007. His concept of the 'shadow banking system' gained prominence during the global Economic crisis of 2007-2009.

McCulley referred shadow banking mainly to non-banking financial institutions/Corporations that engaged in 'maturity transformation'.

Commercial Banks are said to engage in maturity transformation when they use deposits, which are normally short term, to fund loans that are for longer terms. Shadow banks are something similar. They are the conduits for asset backed securities; and the special purpose vehicles for highly leveraged activity, with serious asset liability mismatch.

Hence, Non-Banking Financial Institutions/Companies (NBFIs/ NBFCs) are entities or institutions that provide certain bank-like and financial services, but do not hold a banking license.

In a broader sense, NBFIs/NBFCs are institutions who do not take part in traditional banking services, like deposits in Savings or Current Accounts, but they offer specialized services like Lending of Loans, providing Credit Facilities, Currency Exchange, enabling Systematic Investment Planning, facilitating participation in Money Markets and providing Underwriting & Merger activities for business organizations.

As per the RBI, A Non Banking Financial Company (NBFC) is a company registered under the Companies Act, 2013 of India, engaged in the business of loans and advances, acquisition of shares, stocks, bonds, hire-purchase insurance business or chit-fund business, but does not include any institution whose principal business is that of agriculture, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

The working and operations of NBFCs (and NBFIs) are regulated by the Reserve Bank of India (RBI) within the framework of the Reserve Bank of India Act, 1934 (Chapter III-B) and the directions issued by it.
A few examples of NBFIs/NBFCs are Investment Banks, Money Market Funds, Insurance Companies, Hedge Funds, Private Equity Funds, Mobile Payment Systems, Micro-Lenders, etc.,(Source : www.rbi.org.in)

NBFCs/NBFIs play many essential roles that banks fail to act upon. They provide complementary services to the economy. Through their provision of liquidity divisibility, informational competencies, and risk pooling services, they expand the gamut of existing risks to encourage a risk management culture by drawing clients who are hardly able to tolerate risks and fill the gaps in financial services that otherwise transpire in bank based financial systems.

The many expert committees constituted by the Reserve Bank of India have acknowledged the necessity of NBFCs/NBFIs in the development of sectors like transport and infrastructure, generating substantial employment, helping and increasing wealth creation, assisting in broad base economic development, acting as an irreplaceable supplement to bank credit in rural segments, propelling semi-urban and rural areas first time buyers, financing economically weaker sections, and participating in a major contribution to the state exchequers. Indeed this 'shadow banking' industry running parallel to the Banking industry provides a bigger challenge for the Regulator.

II.2.THE PRIME REGULATOR (RESERVE BANK OF INDIA):-

Reserve Bank of India (RBI) is the central bank of the country and is the regulatory body of the Indian banking system. It enables the issue and supply of the Indian Currency (Rupee"₹") and also controls the credit system in the country. With Federal Reserves (USA), Bank of England (UK), Bundesbank (Germany) and Bank of Japan (Japan), as its global counter-parts, RBI's role as the 'Lender of the Last Resort', makes it the 'Bank for the Banks' and thereby provides directions to the Commercial Banks and Non-Banking Finance Institutes/Companies in India.

Reserve Bank of India is also the creator of the nations' monetary framework and policies, and exercises supervision and control over Banking &Shadow Banking (Non-Banking Finance Institutes/Companies) in India.

II.3. LENDOR OF THE LAST RESORT & REGISTRATION OF SHADOW BANKS:-

In terms of Section 45-IA of the RBI Act, 1934, no Non-banking Financial company can commence or carry on business without obtaining a certificate of registration from the Bank and without having a Net Owned Funds of ₹ 20 Million (₹ 2,00,00,000).

A company incorporated under the Companies Act, 1956, desirous of commencing business of non-banking financial institution as defined under Section 45 I(a) of the RBI Act, 1934 should comply with:

i. It should be a company registered under Section 3 of the Companies Act, 1956.
ii. It should have a minimum net owned fund of ₹ 200 Lakhs.

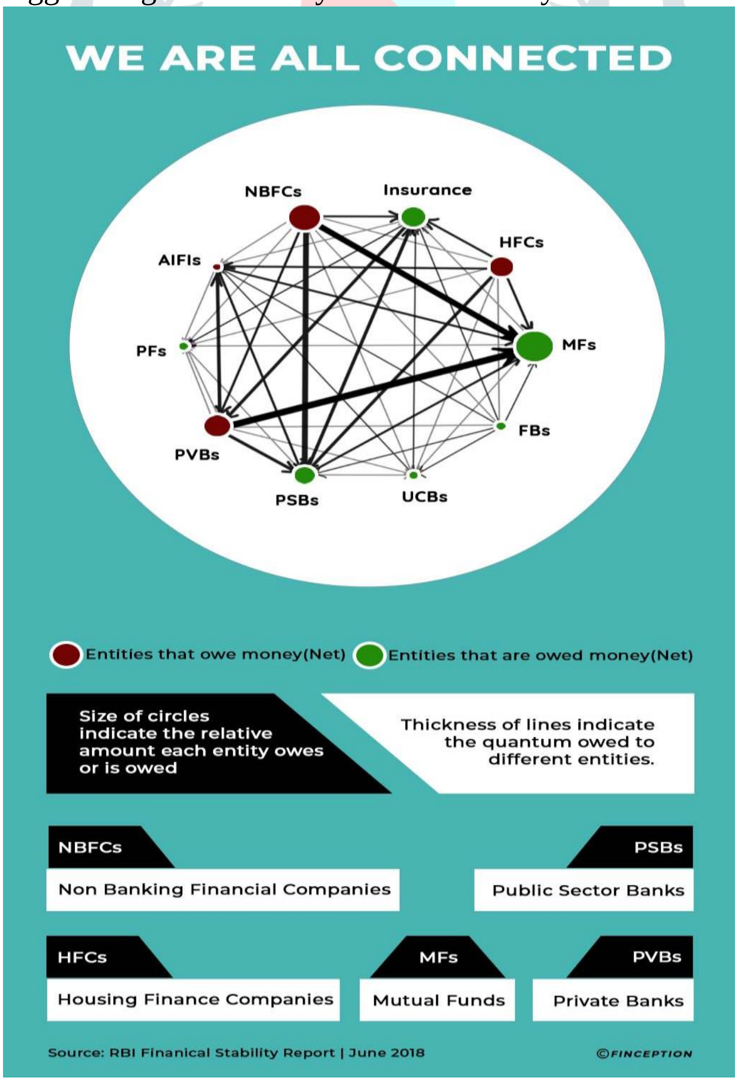
III. STUDY OBJECTIVES:-

III.1. NBFCs & THE FINANCIAL UNIVERSE:-

Our current secondary research focused study then, is to read into the Shadow Banking industry and the role played by RBI – Lender of the last Resort.

In the figure below, we can get a bird's eye view of the spread and impact of the Shadow Banking industry (primarily NBFCs) in the overall Financial Market space.

It goes without saying that, according to the RBI Financial Stability Report, 2018, the Non Banking Financial Services is the Biggest single most entity that owes money.

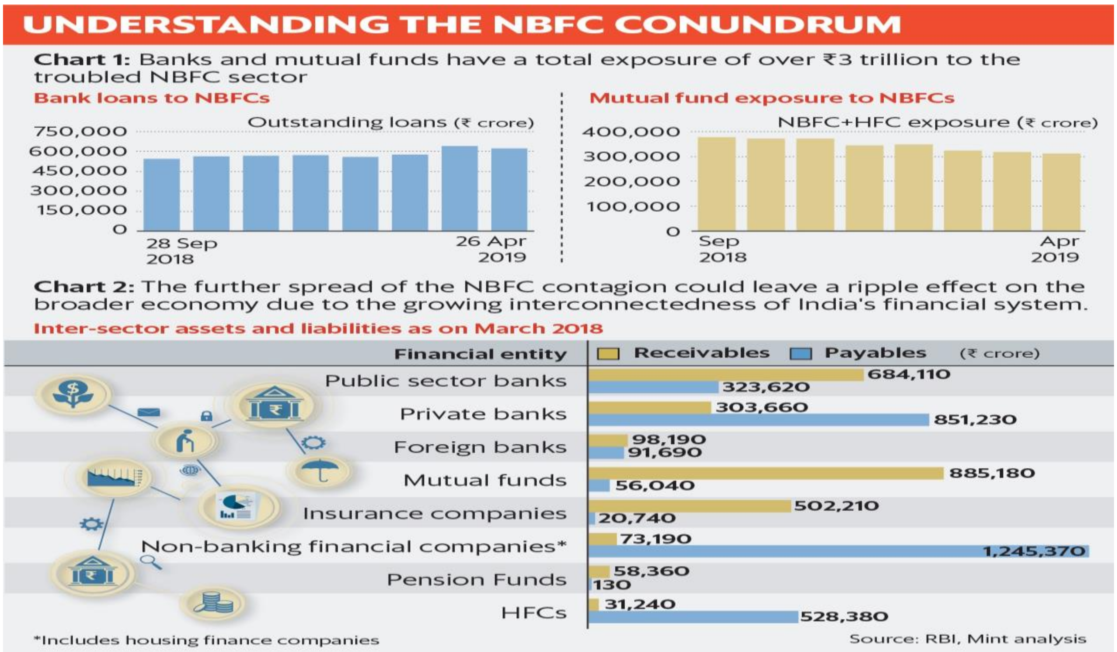


(Source: www.finception.in)

IV. LITERATURE REVIEW:-

IV.1. CRISIS AT THE SHADOW BANKING INDUSTRY:-

In the context of the 2019-20 economic scenario, India's shadow banks found themselves in the midst of a crippling liquidity squeeze that carried the potential to turn into a full-blown crisis.

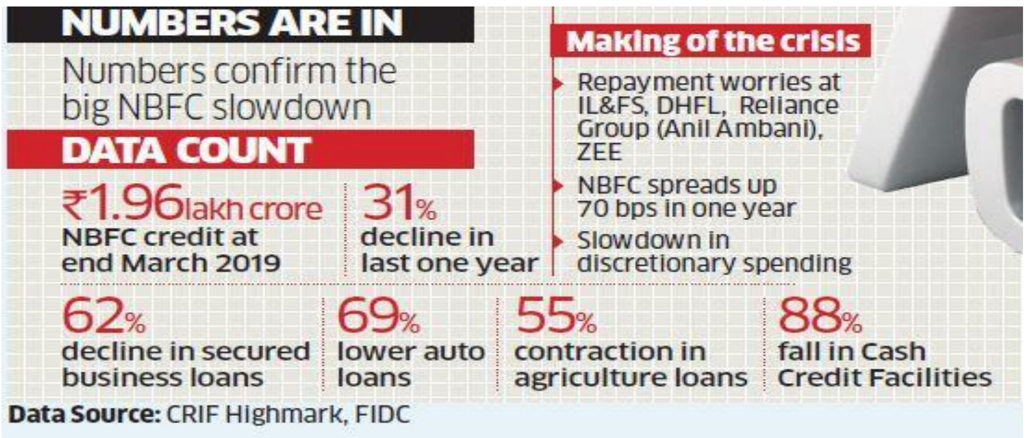


These lenders have been beleaguered since the dawn of 2018, when a series of defaults by IL&FS enforced the government to get involved and expose weaknesses in the sector. The crisis started in Sept'18 when IL&FS Financial Services failed to meet its commercial paper redemption obligations. The IL&FS episode and its aftermath have recurred more profound issues about NBFC/NBFI regulation.

The episode reaffirmed the apprehension of NBFC/NBFI risks impacting the banking system. With a very hefty borrowing, queries were instantaneously raised on the impact of IL&FS default on banks, and also on funds and even corporate holding debt paper issued by the corporation. Essentially this incident highlighted the risks that the supervisory body has always professed in letting NBFCs/NBFIs develop on the back of bank funding.

However the abrupt drying up of NBFC financial support after the episode, also demonstrated the risks NBFCs faced from the banking and financial system.

The asset quality of NBFCs had also depreciated in recent years. Financially weaker NBFCs are prone to mismatches in the short-term maturity. Accordingly, the percentage of non-performing assets of the loan book had progressively amplified, while capital adequacy had declined.



Source: The Economic Times, 26th June 2019

With liquidity meltdown hindering operations, many NBFCs had to deliberately go slow on new advances.

Thus with the expansion in the comparative share of NBFCs in credit, the risks connected with them became larger and more intricate. The risks were also in a twofold direction – NBFCs masquerading a risk to the banking and financial system, and the system in turn, putting the NBFCs in jeopardy.

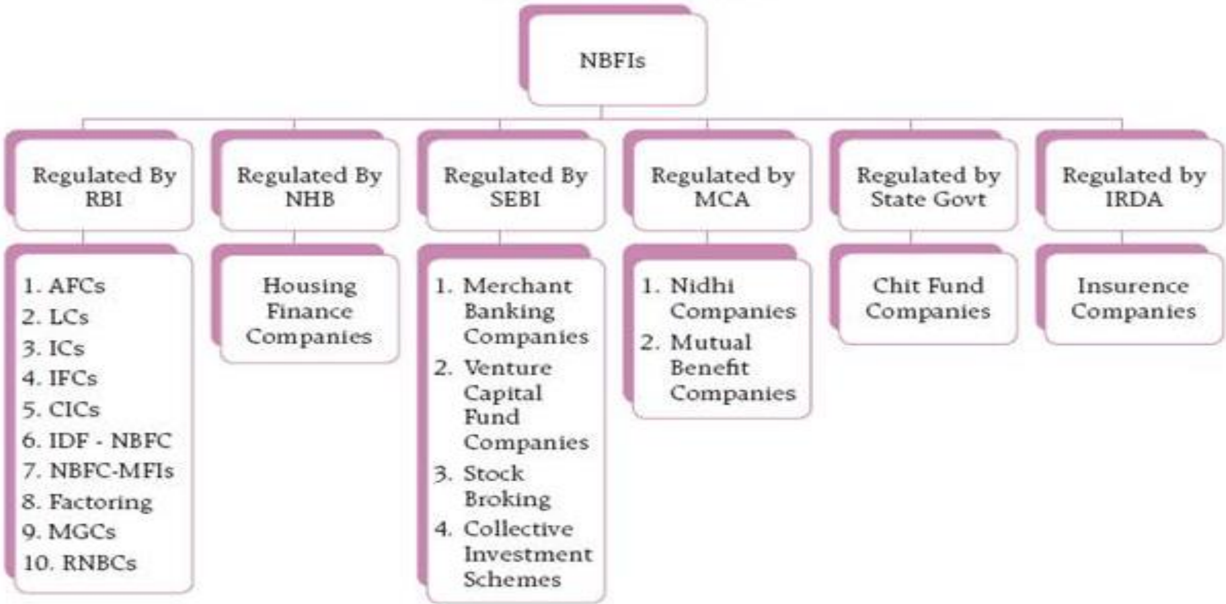
IV.2. SHADOW BANKING ('NBFI/NBFC') UNIVERSE & REGULATOR/S:-

As mentioned in www.rbi.org.in, Reserve Bank of India regulates the working and operations of the Non-Banking Finance Companies within the framework of the Reserve Bank of India Act, 1934 (Chapter III-B) and the directions issued accordingly.

As per the new RBI norms issued on 09.11.17, Non-Banking Finance Companies, are restricted to outsource core management functions like internal audit, management of investment portfolio, strategic functions for KYC, compliance functions, sanction of loans, etc.

The Reserve Bank, under the RBI Act 1934, has been given the powers to register, lay down policy, issue directions, inspect, regulate, supervise and exercise surveillance over NBFCs that meet the 50-50 criteria of principal business.

The Non-Bank Finance Institutions' (NBFI) universe with their respective regulators can be represented as under:



Supervision & Surveillance under the Companies Act 2013
(Source: www.rbi.og.in)

V. FINDINGS & DISCUSSIONS:-

Post going through all possible available literature available in the secondary space, the following can be put forward.

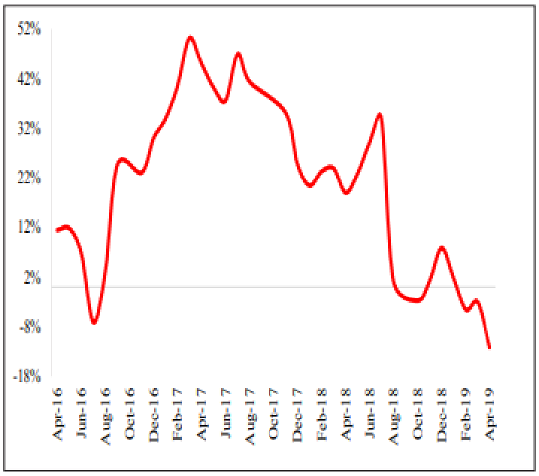
V.1. CONCERNS/CHALLENGES FOR NON BANKING FINANCE:-

- COMPLICATIONS in obtaining License: The process of procuring an NBFC/NBFI license is quite difficult.

- Difficult COMPLIANCES: Due to the varied number of compliances for different types of NBFCs/NBFIs, it becomes really difficult to figure out how and when to file the prescribed returns.

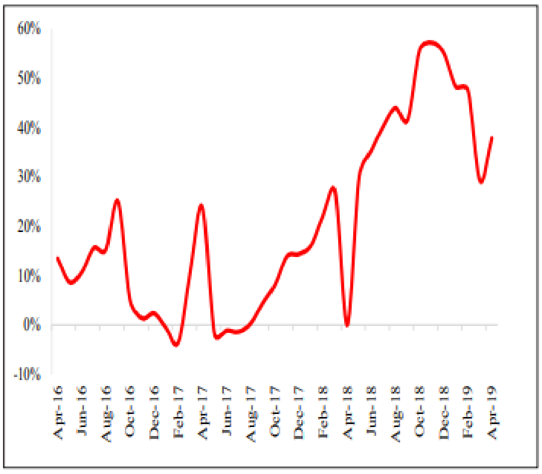
- Funding issue due to the absence of REFINANCING option: NBFCs/NBFIs have to hinge on banks, competitors, or the capital markets for raising resources every time. This is unfavourable to the sustainability of their growth in case of distress. Furthermore, the flow of funds from the sources could dry up without any notice.

Growth in deployment of funds by Mutual Funds to NBFCs



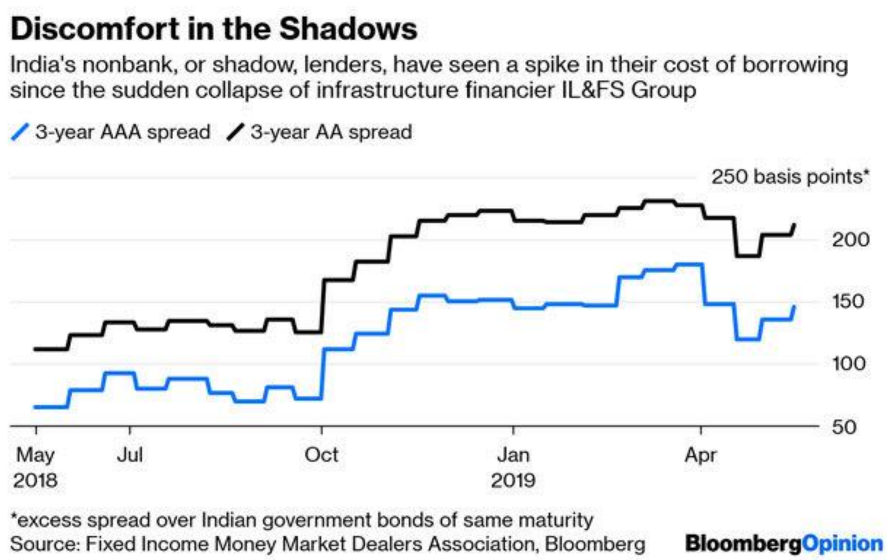
Source: SEBI
Refer: The Economic Survey, 2019

Growth in bank credit to NBFCs



Source: RBI
Refer: The Economic Survey, 2019

- Absence of Flexibility in the CLASSIFICATION of NPAs: For large corporations, the Non-Performing Asset norms are quite justified. However, businesses with irregular cash flow have a cascading effect resulting in delayed payments.
- Lack of Statutory RECOVERY Tool: Even after revision of asset classification norms, there is still a lack in statutory recovery tools.
- Limited LEVERAGE RATIO for Asset Size less than ₹500 Crores: Small NBFCs are exempted from the maintenance of the Capital Adequacy Ratio (CRAR). But they can't exceed the leverage ratio beyond 7. This is restrictive, indeed!.
- Several REPRESENTATIVE bodies: The NBFC/NBFI sector is at a developing stage and so in the interest of developing its various segments, setting up a single representative body could be a better alternative.
- Requirement of CAPACITY Building: NBFCs/NBFIs need to work on creating a receptive ecosystem for capacity building on both collective and individual basis - are currently lacking in this.
- Disparate TAX Treatment: Tax structures between Banks and NBFCs/NBFIs have a huge disparity.
- Scarcity of DEFAULTER database: As NBFCs/NBFIs do not get default lists from banks, they are susceptible to credit risk due to lack of crucial information of credit worthiness.



- Removal of PRIORITY SECTOR status: The collaboration model, "Wholesaler-Retailer" between the NBFCs/NBFIs& Banks ensures the credit flow to under-served sections of the society. However, RBI needs to specify a cap to route a maximum fixed percentage of the total bank lending priority sector through NBFCs.

- Minimum CREDIT Rating for deposit taking NBFCs: As per the revised regulatory framework, it is obligatory for NBFCs/NBFIs accepting deposits to get investment-grade credit. In case the rating of any NBFC/FI is downgraded to below the minimum investment grade rating, it can't accept public deposits.

VI. PLAUSIBLE RECOMMENDATIONS ANDSOLUTIONS:-

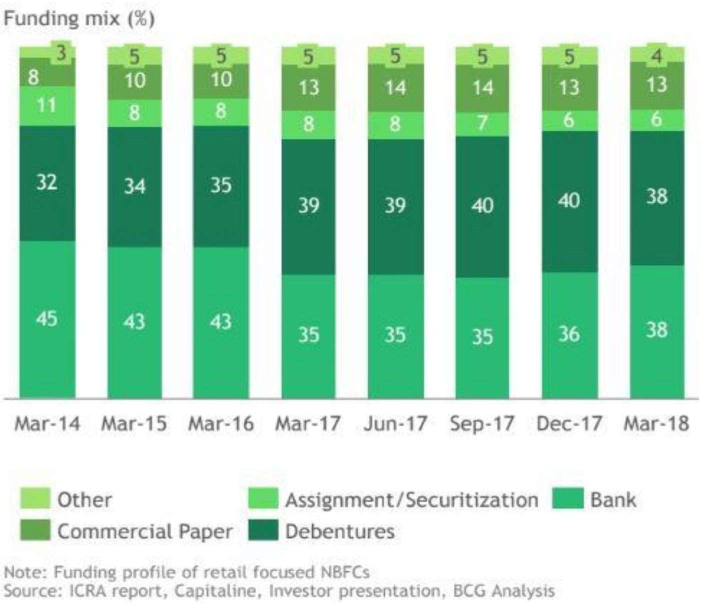
There is a reason why IL&FS defaults have prompted many market writers to invoke the Lehman crisis: there was an uncanny similarity in the absence of cynicism during the US sub-prime boom and India's NBFC surge. (www.economictimes.com).

India has been witnessing a huge surge in consumer leverage in recent years and these non-bank intermediaries have been growing this lending faster than banks. Every third multi-bagger of last five years would be an NBFC. (Economic Times, Sept 28, 2020).

While the possible answers to the twelve aforementioned concerns and challenges are but the ideal solutions to the crisis at hand, a few of the other recommendations can be as mentioned under.

- Co-originating LENDING for funding issues

As seen from the chart below – showing the shadow banking funding mix till FY 2018, most of the shadow banking units raise funds by issuing debentures and commercial papers and borrow from banks. This led to their cost of funding actually falling despite their being a spike in systemic rates – as commercial papers were relatively cheaper.



Source: Boston Consulting Group

As the research paper at Kotak Securities mentioned, we don't see liquidity risk, but the risk-averse stance of debt markets is likely to lead to higher funding costs in the near term.

- PARTNERING with Fin-Tech players of the Market

The traditional NBFCs have an inherent advantage which Fin-Tech companies don't. Similarly, Fin-Tech companies have agility and technology, which acts as a great equaliser (www.pwc.in). Accordingly tying up with Fin-Tech companies will indeed be a boon for the Shadow Banking Industry.

Be it Artificial Intelligence, Robotics Process Automation, Advanced Analytics, API, Block-chain, Chat-bots and NLP – Fin-Tech can indeed be beneficial to the Shadow Banking Industry in more ways than one.

Fin-Techs today can not only allow the NBFCs to lower their costs when it comes to increasing their customer base, by lowering customer acquisition costs; it can also enable servicing existing customers or de-risking the portfolio while trying to overcome the increasing formal credit penetration in a growing economy that the Shadow Banking industry is mired in now.

- Creating an effective BUSINESS PLAN and continuous MONITORING

As has been repeatedly found out, an effective is crucial for any business purpose and NBFCs are no exception. Accordingly having an effective Business Plan for the Shadow Banks necessarily serves the following objectives:

- It enables presenting the information to the stakeholders such as the prospective investors, financial institutions, and funding institutions for generating the most important aspect of generating loan for Finance.
- The Plan acts as a motivator for the organisations to achieve the goals.
- Such a plan enables keeping the employees of the organisation to be updated with the objectives and be aware of the defined roadmap.
- And, most importantly, a robust Business Plan would certainly have a framework to operate during challenging situations.

- "NAME & SHAME" policy for Loan DEFAULTERS

Tightening the noose around wilful defaulters, the government had recently asked banks to 'name and shame' such borrowers by publishing their photographs and other details.

A communiqué from the Finance Ministry categorically specified that, "Lending institutions shall formulate a policy with the approval of their board of directors which clearly set out the criteria for publication of photographs of wilful defaulters".

Had this been the case right from the word 'go', things may not have been blown out of proportions.

- Creating a proper RISK MANAGEMENT framework

Risk management is of paramount importance for the NBFCs or the Shadow Banks, given the implications on the ability to successfully raise funds from the market and potentially enlist on the secondary markets through IPOs in the medium to long term.

A report from ASSOCHAM stated that in order to develop and implement risk management frameworks to proactively to detect, manage and mitigate internal and external risks, 'With recent events increasing the scrutiny on NBFCs and their operations, it is imperative for players to build robust risk and governance models as they grow their lending business'.

- CAPACITY BUILDING, Documentation and Compliances

One of the critical lookouts for the Shadow Banking Industry is the lookout for Capacity Building on both an individual as well as collective basis.

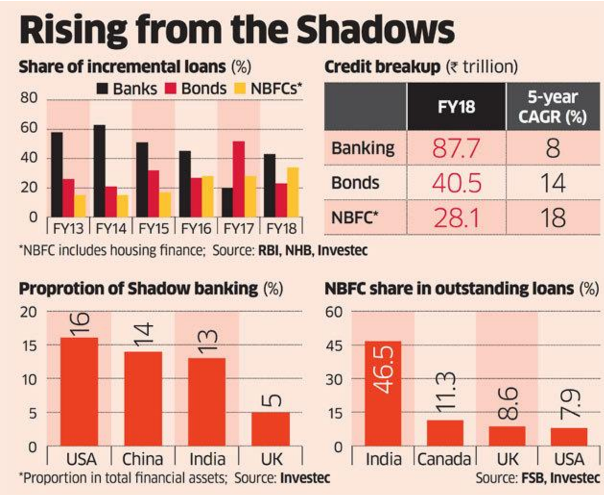
Further, the lack of statutory recovery tool complicates the matter to no-ends.

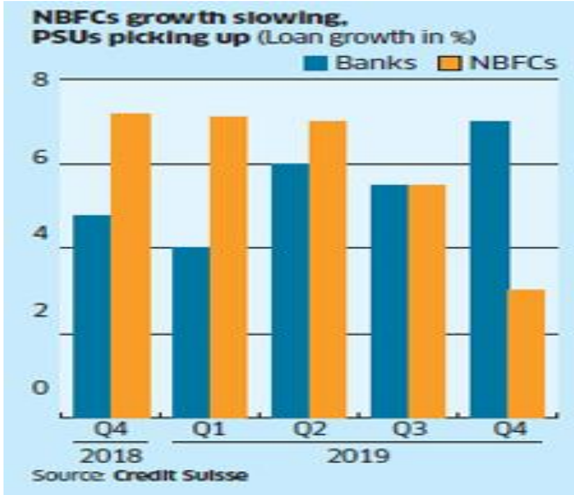
Be it the Funding issues, Absence of Flexibility in Loan NPA Classification, Limited Leverage Ratio, Disparate Tax treatment, and Minimum Mandatory Credit Rating, framing a proper guideline on the rules, regulations, policies, Licences and a lookout for any loophole with a hawk's eye are but some of the critical success factors (CSFs) when referring to the some of the steps for arresting the concerns existing at the shadow banking Industry.

VII. CONCLUSION:

In the past 10 years, the Non Banking Finance Companies/Institutions have survived three stress cycles. "In 2009-10 (financial crisis) and 2013-14 (taper tantrum), there were four to eight quarters of subdued growth and then (things) picked up," so said Gurpreet Chhatwal, president, CRISIL Ratings.

The same also gets corroborated in the two graphical representations, as under.





Indian NBFCs during its hey-days
Source: The Economic Times, 26th Oct, 2018

Indian NBFCs Growth in 2019
Source: The Economic Times, 05th Jun, 2019

Hence, to conclude, in the words of honourable Finance Minister Nirmala Sitharaman, "The RBI is constantly monitoring the health of NBFCs and I am in touch with them. I don't want anyone to fall off the cliff" (@ HTLS, Dec 06'19). Understandably, the government and regulators (primarily RBI) have announced a slew of measures to shore up support for these lenders.

However without a strong balance sheet or pedigree, and the COVID 19 pandemic hitting the economy really hard (especially for Q1 20-21 and to a smaller extent Q4 19-20), the investors don't seem to be too optimistic about the 'shadow banks'. Challenging days, ahead!.

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